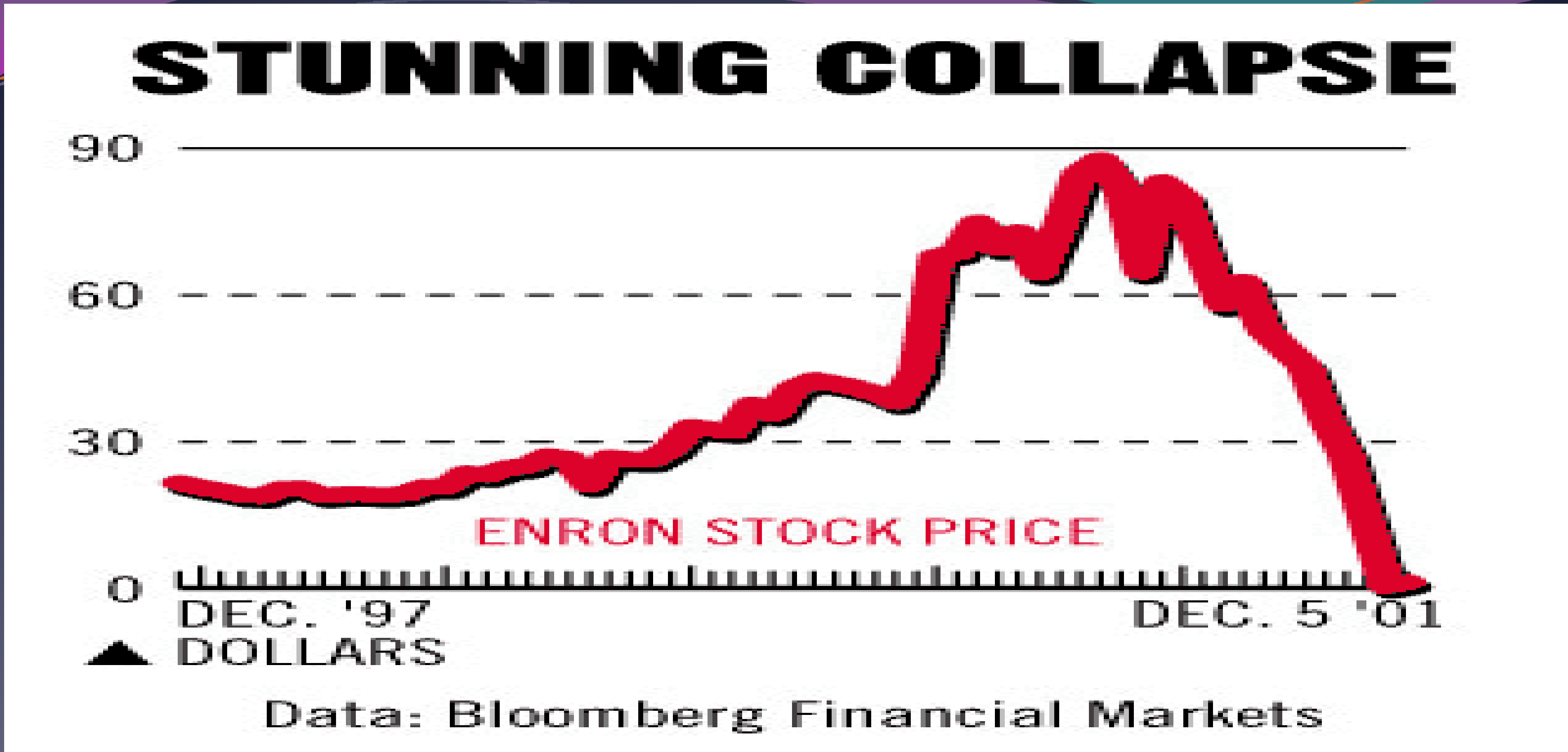
World's Biggest Accounting Disasters

ENRON and WORLDCOM

Presented By:
Group 7

Rise and Fall of Enron (The Accounting Disaster)



"The company's success was based on artificially inflated profits, dubious accounting practices, and fraud."

ENRON – A Brief History

- **Deregulation in energy power market started**
- **In 1985 Enron was born from the merger of Houston Natural and Inter North**
- **Contracts with gas sellers and buyers**
- **Soon got the control of over 25% of all gas business**

"Mid 1980s: Enron business entirely in the USA, focused on gas pipelines and power"

ENRON – A Brief History

- Entered into the derivative business
- Began trading in commodities like steel, coal, pulp, paper, etc.
- By 2000, stepped into the dot com business – Enron Online
- Judged as the most innovative company for six consecutive years by FORTUNE.

"2001: Enron trading in hundreds of commodities Interests in: USA, South America, Europe, Asia and Australia"

•Global energy crises by late 90s.

•In India, lost the Dabhol Power project, in which Enron had committed $2.9bn.

•Beginning of Dot.Com bubble crises and fallout of blockbuster internet deal.

•Enron delivered smoothly growing earnings (but not cash flows).

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- Enron was a trading company, yet was given very high PE of 70 as compared to PE of 20, given to other trading companies

- During 2000, Enron's derivatives-related assets increased from $2.2bln to $12bln and derivates-related liabilities increased from $1.8bln to $10.5bln

- Enron's top management gave it's managers a blank order to "just do it"

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Creative Accounting

- Accounting practices that may follow the letter of the rules of standard accounting practices, but certainly deviate from the spirit of those rules.
- Non-operational incomes (sale of fixed assets) being major source of income.
- Deferment of revenue expenses to inflate bottom line.
- Extension of Accounting year to include major gains in coming months.
- No provision for doubtful debts to inflate bottom line.

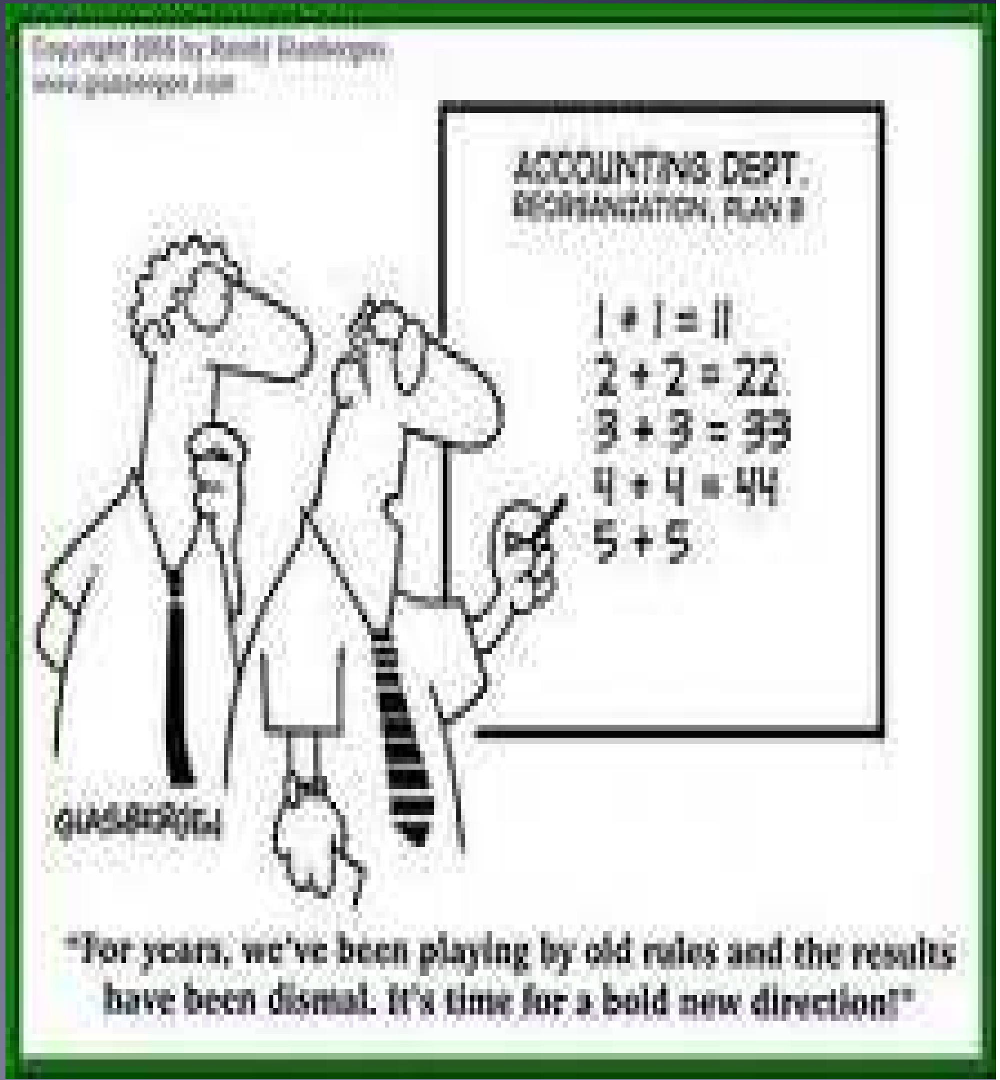


Table Enron's Cash Flow Analysis (in Millions)

	1998	*1999*	*2000*
Revenues			
Natural gas and other products	13,276	19,536	50,500
Electricity	13,939	15,238	33,823
Metals	—	—	9,234
Other	4,045	5,338	7,232
Total revenues	31,260	40,112	100,789
Less: noncash revenues (see footnotes)	(1,984)	(2,533)	(4,794)
Cash revenues	29,276	37,579	95,995
Cash cost of sales	26,381	34,761	94,517
Cash gross margin (deficit)	2,895	2,818	**1,478**
Operating expenses	2,473	3,045	3,184
Cash operating income (loss)	422	(227)	**(1,706)**

Source: Prepared from information provided in the Enron 2000 *Annual Report*, selected filings by Enron with the Securities and Exchange Commission, and with the assistance of Charles Conner, formerly an executive at Enron. The data was synthesized by Charles Conner, Mark Storrie, and Richard Bassett.

Financial Ratios for Enron

	1996	1997	1998	1999	2000
Net Profit Margin	4.395%	0.518%	2.249%	2.263%	0.971%
Return On Assets	3.619%	0.466%	2.395%	2.675%	1.495%
Return On Equity	22.583%	1.915%	10.165%	10.581%	9.463%
Debt Ratio	76.929%	75.089%	75.986%	71.331%	82.489%
Debt/Equity	0.89954	1.11321	1.04384	0.74723	0.74542

Enron's Accounts: The Company announced the restated figures

Year	Reported Income	Revised Income	True debt restated by	True equity restated by
1997	$105m	$77m	Up $771m	Down $258m
1998	$733m	$600m	Up $561m	Down $391m
1999	$893m	$645m	Up $685m	Down $710m
2000	$979m	$880m	Up $628m	Down $754m

Operandi MODUS

Creative Accounting

Mark to Market

Financial Audit

Special Purposes Entities

Mark to Market Accounting
(The Prescribed Way)

To revalue the Value of Assets and Liabilities on the basis of fair market value.

Any increase (decrease) in the net value is added to (subtracted from) any profit distributions to shareholders in determining the business' profit or loss.

In theory, mark-to-market gives investors the most useful information

Mark to Market Accounting
(The ENwRONg Way)

Used this principle to their advantage by increasing the values of their Income.

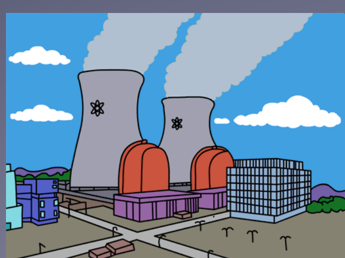
ENRON

Long Term Contract to Supply Power

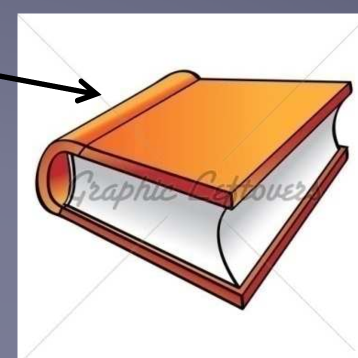
City Municipal Deptt

Revenue to be Generated once the Deal is Executed

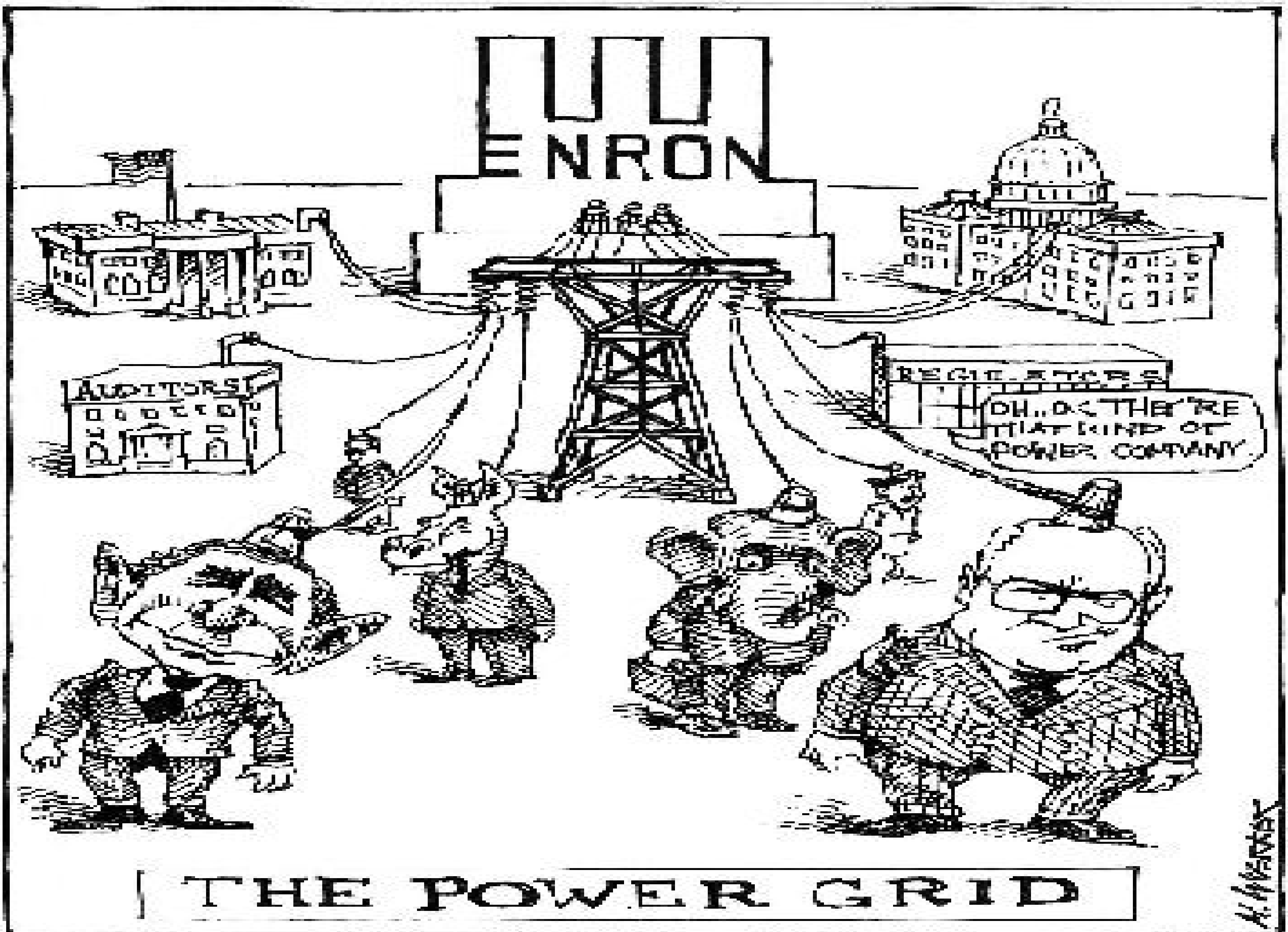
Revenues entered into Book of Accounts on signing of deal instead of execution of it



Under Construction Power Plant



Book of Accounts


ENRON
AUDITORS
OH... OK. THEY'RE THAT KIND OF POWER COMPANY
THE POWER GRID

Special Purposes Entities
(The Prescribed Way)

These "esoteric financial vehicles" were originally defined as entities created for a limited purpose, with a limited life and limited activities, and designed to benefit a single company

They may take the legal form of a partnership, corporation, trust, or joint venture

They are basically used to keep Debt off the Balance Sheet

Special Purposes Entities
(The ENwRONg Way)

Enron used SPEs in ways that nobody had every heard of before:

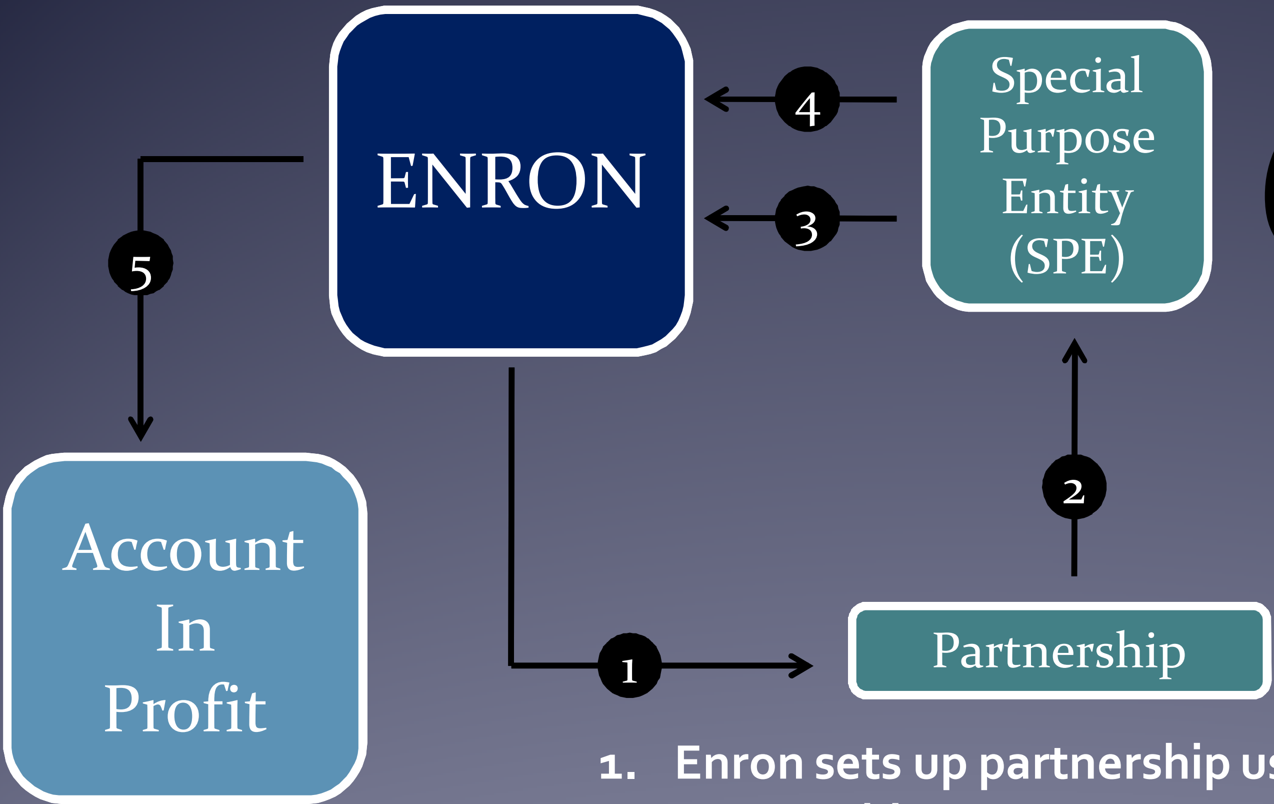
- They formed an SPE, which formed an SPE, which formed an SPE

- They also did interactions between SPEs and themselves

Some of the SPEs created were:

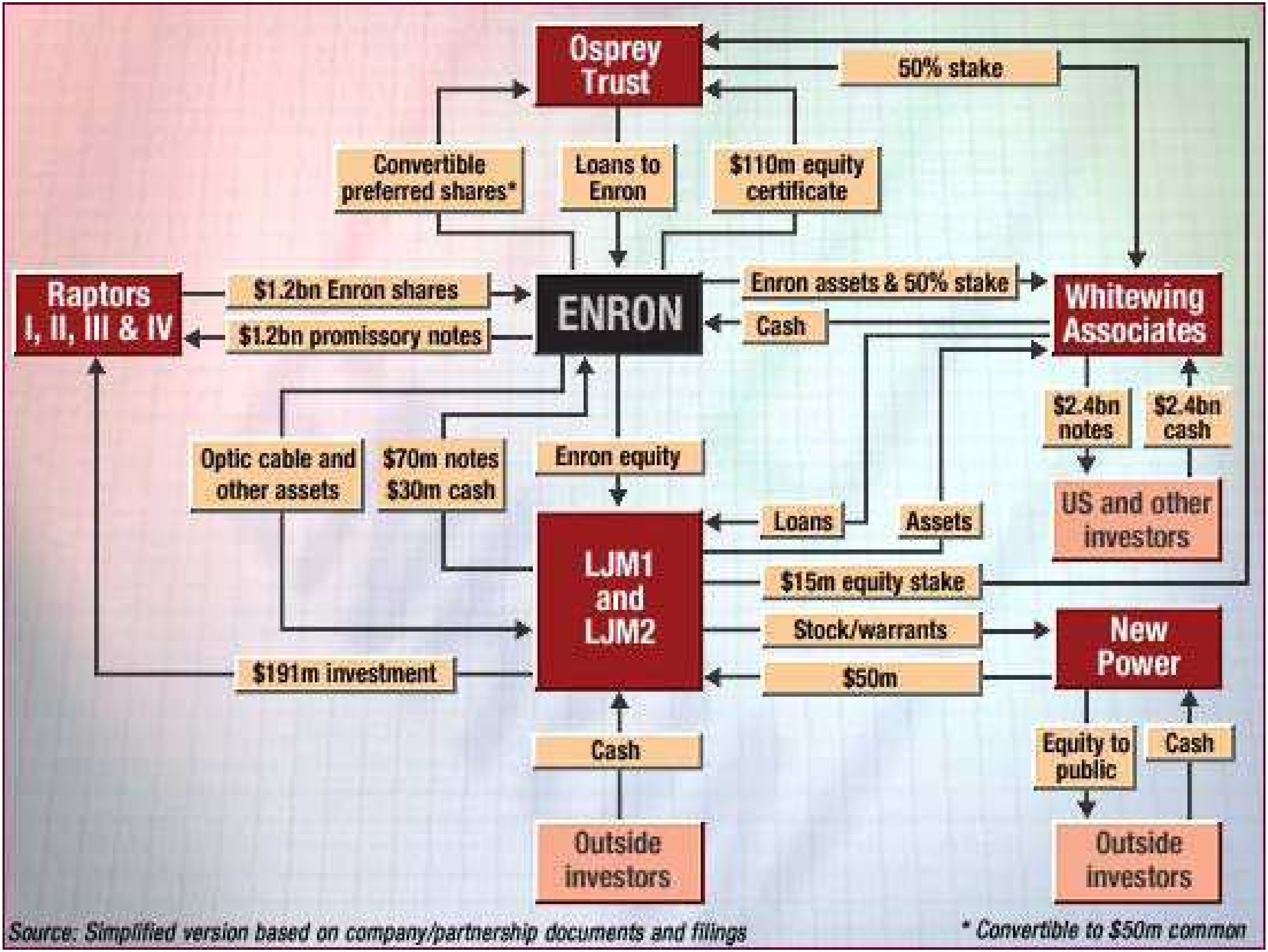
- Chewco
- Whitewing
- LJM and Raptors

Special Purposes Entities



> *A huge hole had opened in the accounts.*
> *-BBC*

1. Enron sets up partnership using stock as funding
2. Partnership sets up SPE
3. SPE agrees contract to pay Enron if its investment declines in value
4. Payment made as investment declines
5. Payment posted as profit, even though it is Enron's own money



Osprey Trust
Convertible preferred shares*
Loans to Enron
$110m equity certificate
50% stake
Raptors I, II, III & IV
$1.2bn Enron shares
$1.2bn promissory notes
ENRON
Enron assets & 50% stake
Cash
Whitewing Associates
$2.4bn notes
$2.4bn cash
US and other investors
Optic cable and other assets
$70m notes $30m cash
Enron equity
Loans
Assets
LJM1 and LJM2
$15m equity stake
Stock/warrants
New Power
$50m
$191m investment
Cash
Equity to public
Cash
Outside investors
Outside investors
Source: Simplified version based on company/partnership documents and filings
* Convertible to $50m common

The ENwRONg Way of Financial Auditing

•Arthur Andersen was one of the world's five leading accounting firms.

•Andersen executives including chief Enron auditor David Duncan, decided to consult lawyers over whether or not the partnerships were legal

•Andersen told Enron that it had no other choice but to change the way it was accounting for its special partnerships.

The ENwRONg Way of Financial Auditing

- At some point after this, staff in Andersen's Houston office began shredding documents relating to Enron.

- Legal examination concluded that the partnerships in question, Raptor and Condor, had been approved by Andersen.

- Was paid $52mn in 2000, the majority for non-audit related consulting services.

Highway To Hell
(The Course of Events)

- Decline in Investors' Confidence
- Restructuring Losses and SEC Investigation
- Liquidity Concerns
- Credit Rating Downgrade
- Proposed buyout by DYNEGY
- Filing of Bankruptcy
- Trials
- Measures taken to prevent such fiascos in future

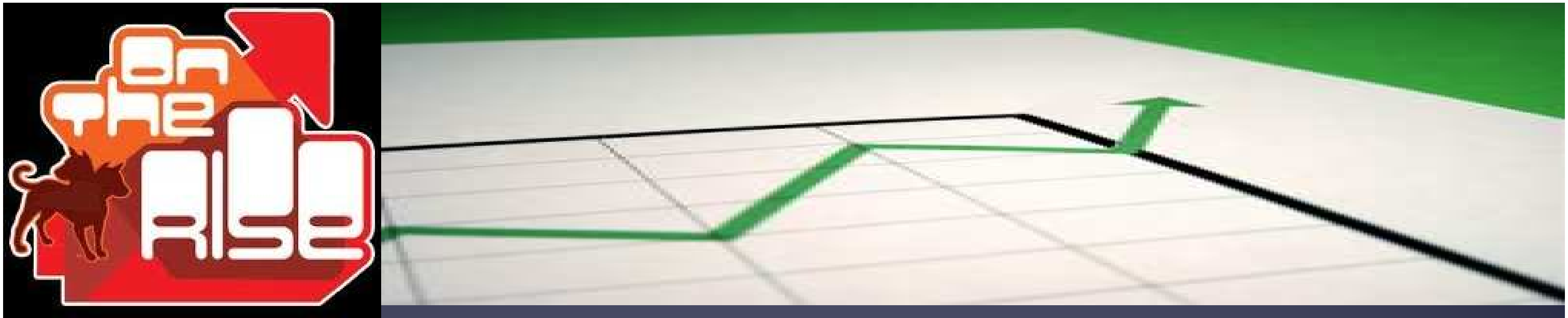
The Chronology Of The Fall

DECEMBER 2, 2001

ENRON

GOES BANKRUPT AFTER INFLATING EARNINGS BY SIX HUNDRED MILLION DOLLARS LOOSING EMPLOYEES 401K LIFESAVINGS AND CREATING THE LARGEST EVER BANKRUPSY IN THE HISTORY OF THE US

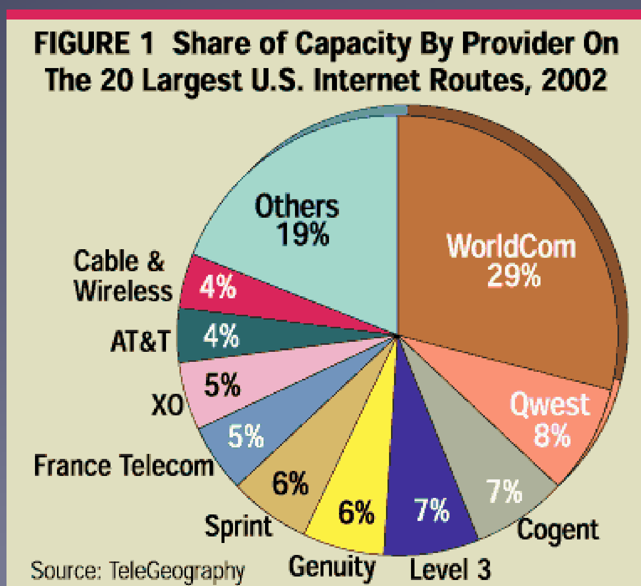

WORLDCOM



- In 1983, Murray Waldron and William Rector started a business in Mississippi, offering long distance services at a discount and named it Long Distance Discount Services (LDDS)
- Provided
  - Internet Services
  - Long Distance and various other phone services for a cheaper price than competitors
- Bernie Ebbers became the CEO in 1985 and grew the company through series of acquisitions and renamed it to Worldcom in May 1995.

THE RISE... (CONTINUED...)

- The firm made around 75 mergers and acquisitions of other telecommunications firms that boosted its reported revenues from $154 million in 1990 to $39.2 billion in 2001, placing it 42nd among Fortune 500 companies.
- Held responsible for waking up somewhat sluggish telecom industry in the early 90's



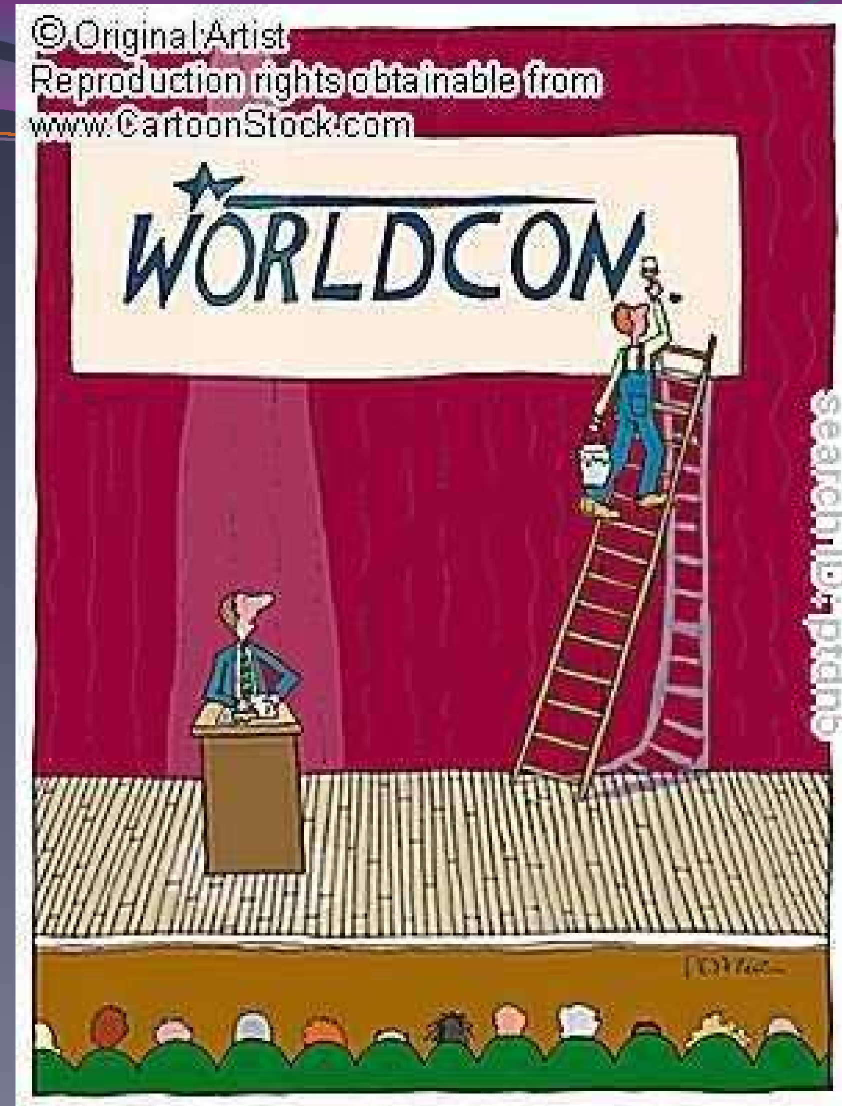
Bought competitor MCI ($34.5 billion) in 1998 making it the 2nd largest long-distance operator with over 20 million customers.

Financial Highlights	1994	1999	2001	2004
($ in billions)				
Revenues	$2.2	$37.1	$35.2	$20.7
Total Assets	$3.4	$91.1	$103.9	$17.1
Employees (in 000's)	7.5	97.6	87.8	40.4
Market Cap.	$3.3	$150.5	$42.8	$ 6.4
Debt	$0.8	$ 13.1	$30.0	$ 5.9
Total Capitalization	$4.1	$163.6	$72.8	$12.3

Source: Original SEC Filings , before restatements for accounting fraud.

AND THE FALL…

- **Strategy**: Growth through acquisitions
- **Currency**: WorldCom stock
- **Peak**: Acquisition of MCI in 1998
- Attempted to buy Sprint in 2000 but anti-trust regulations wouldn't allow the acquisition.
- CEO Ebber's continued to feed Wall Street' s expectations of double-digit growth, and demanded that his subordinates
meet those expectations, but did not provide the leadership or managerial attention to meet them

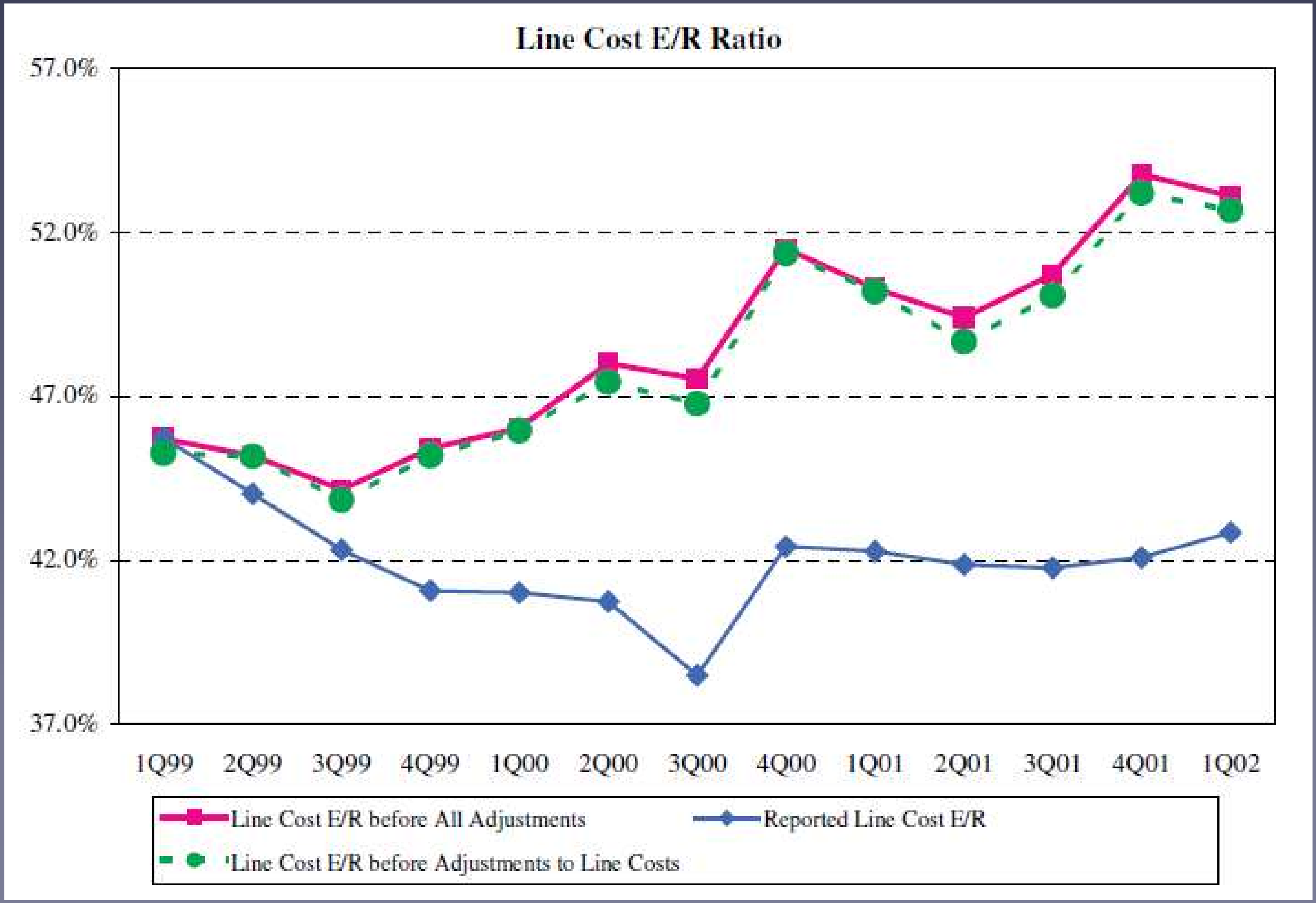


Manipulated earnings by :

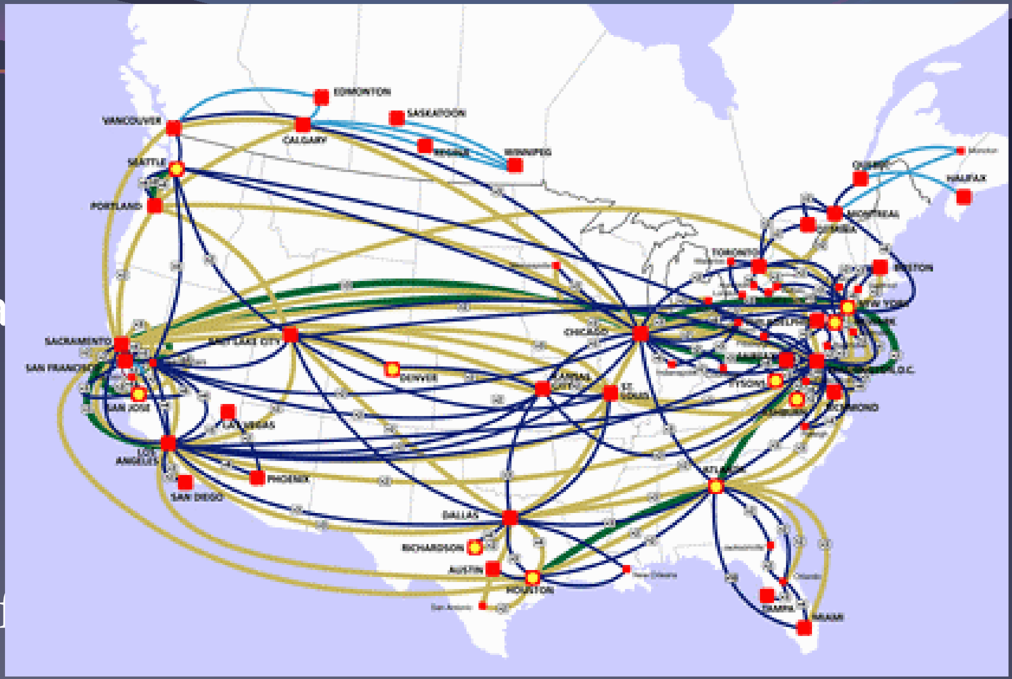
❖Reduction of line cost

❖Inflation of revenue

OBJECTIVE: Hold reported line costs to approximately 42% of revenues, and to continue reporting double-digit revenue growth when actual growth rates were generally substantially lower.



LINE COST REDUCTION



• Line costs are the costs of carrying a voice call or data transmission from its starting point to its ending point.

• Accounted for approximately half of WorldCom's total expenses.

Improper Adjustments to Line Costs
(millions of dollars)

1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	Total
(41)	103	140	396	493	683	832	862	771	606	744	942	798	7,329

Line cost adjustment was achieved in 2 ways:

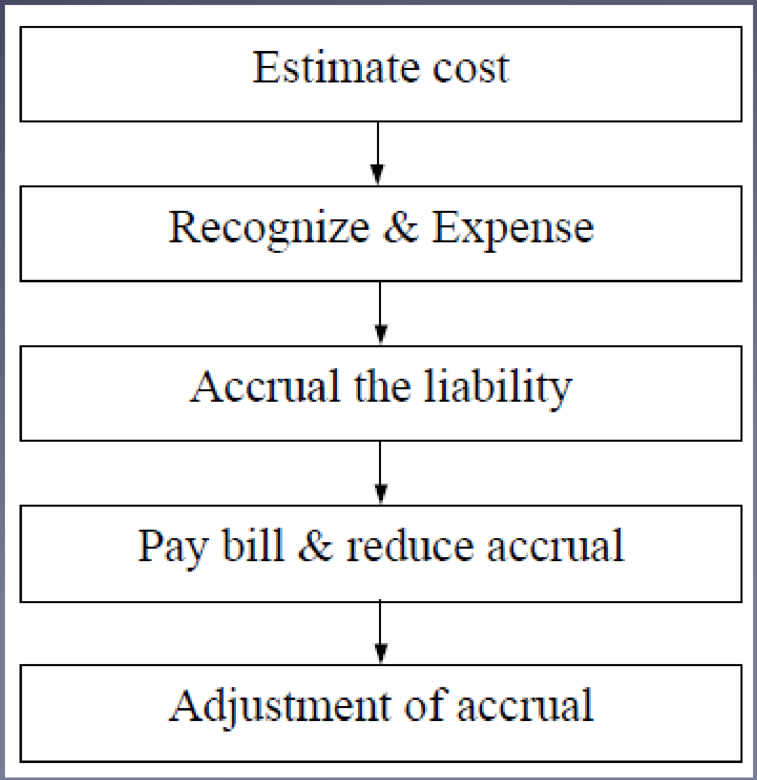
1999 and 2000 - Releases of accruals

2001 and early 2002 - Capitalization of operating line costs

Release of accruals

In 1999 and 2000, WorldCom reduced its reported line costs by approximately $3.3billion.

Accrual Process



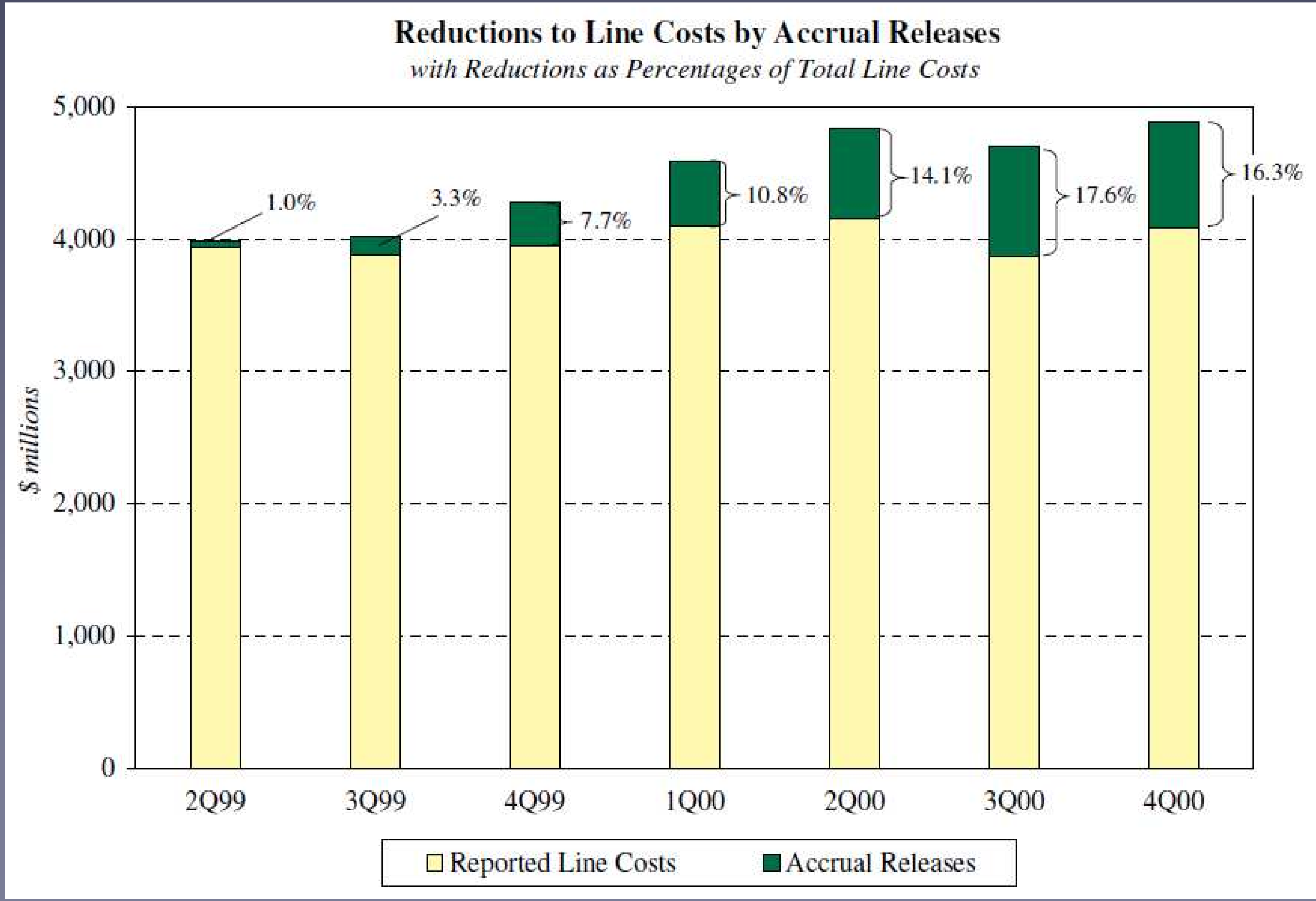
WorldCom's violation!!

- Accruals were released without any apparent analysis
- Did not release excess accruals
- Released accruals established for other purposes

Reductions to Line Costs from Accrual Releases

(millions of dollars)

Line Costs	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	TOTAL
Domestic	40	100	90	89	305	828	477	**1,929**
International	--	31	239	370	374	--	170	**1,184**
UK	--	--	--	34	--	--	--	**34**
Other	--	--	--	--	--	--	150	**150**
Total	40	131	329	493	679	828	797	**3,297**

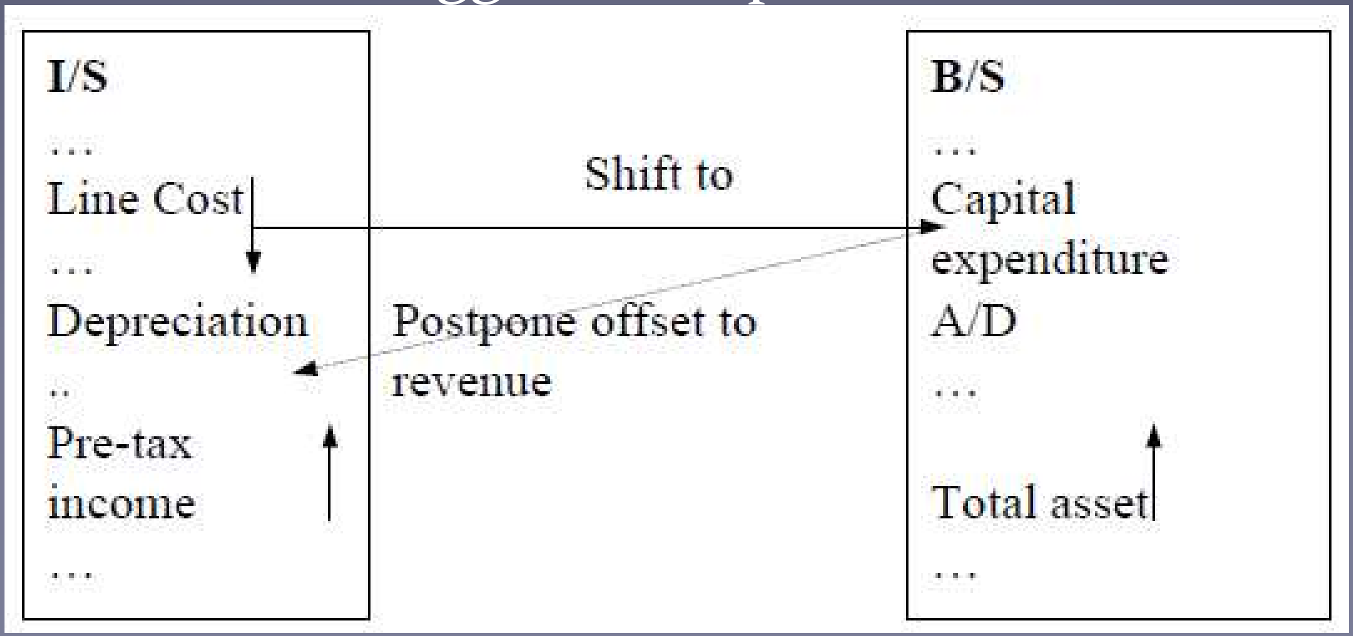


Features of accrual release

- ❖ Directed by senior members, including CFO Scott Sullivan, Controller David Myers, and Buddy Yates, Director of General Accounting
- ❖ Did not occur in the normal course of day-to-day operations, but instead in the weeks following the end of the quarter in question
- ❖ Timing and amounts of the releases were not supported by contemporaneous analysis or documentation
- ❖ WorldCom employees involved in the releases understood irregularities and some of them had raised concerns

Capitalization of line costs

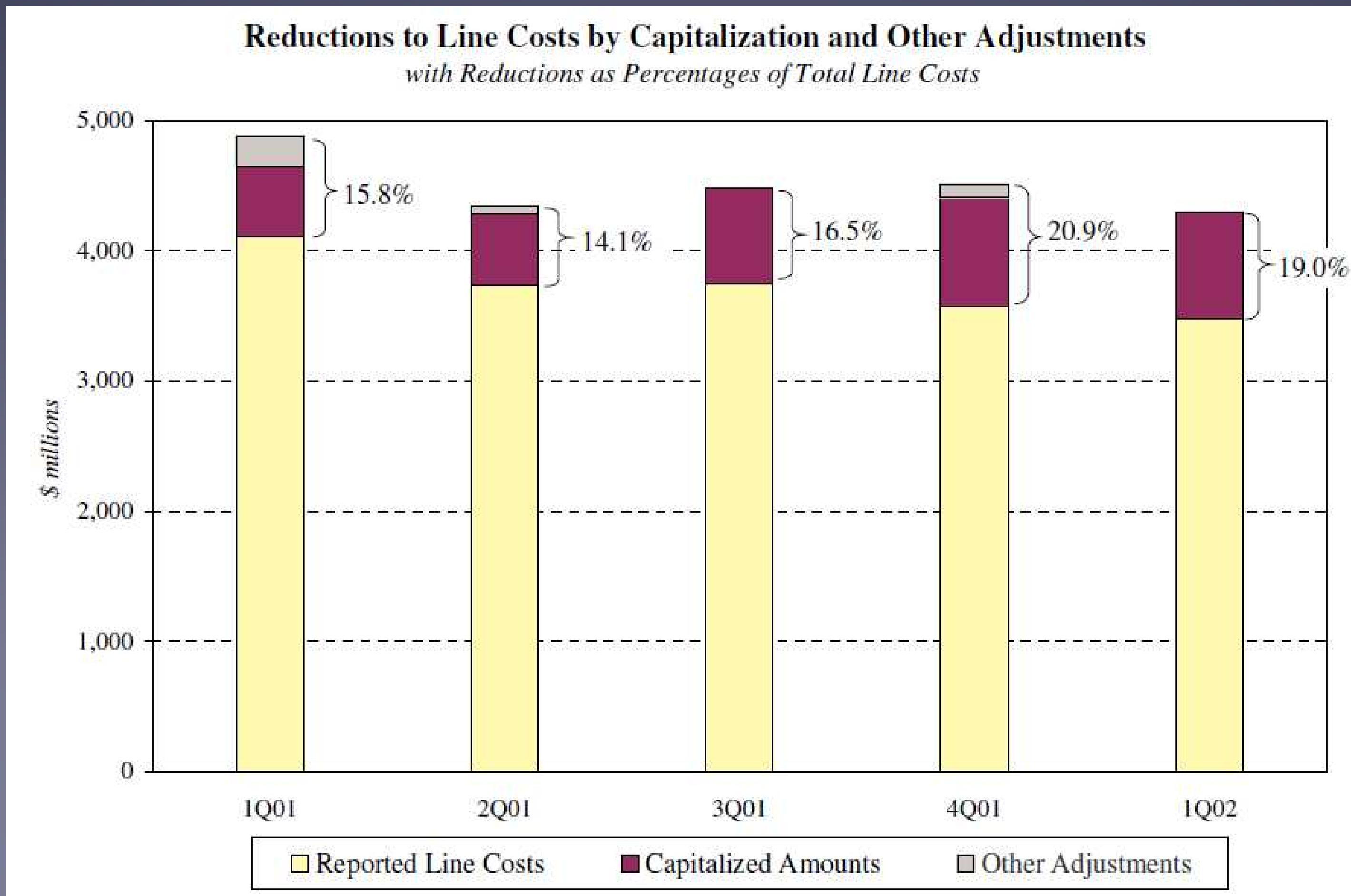
- ❖ From the first quarter of 2001 through the first quarter of 2002, reported line costs were reduced by $3.8 billion, principally by capitalizing $3.5 billion of line costs
- ❖ Ongoing, operating expenses need recognize immediately
- ❖ Capitalized it to exaggerate its pre-tax income



Reductions to Line Costs by Capitalization and Other Adjustments

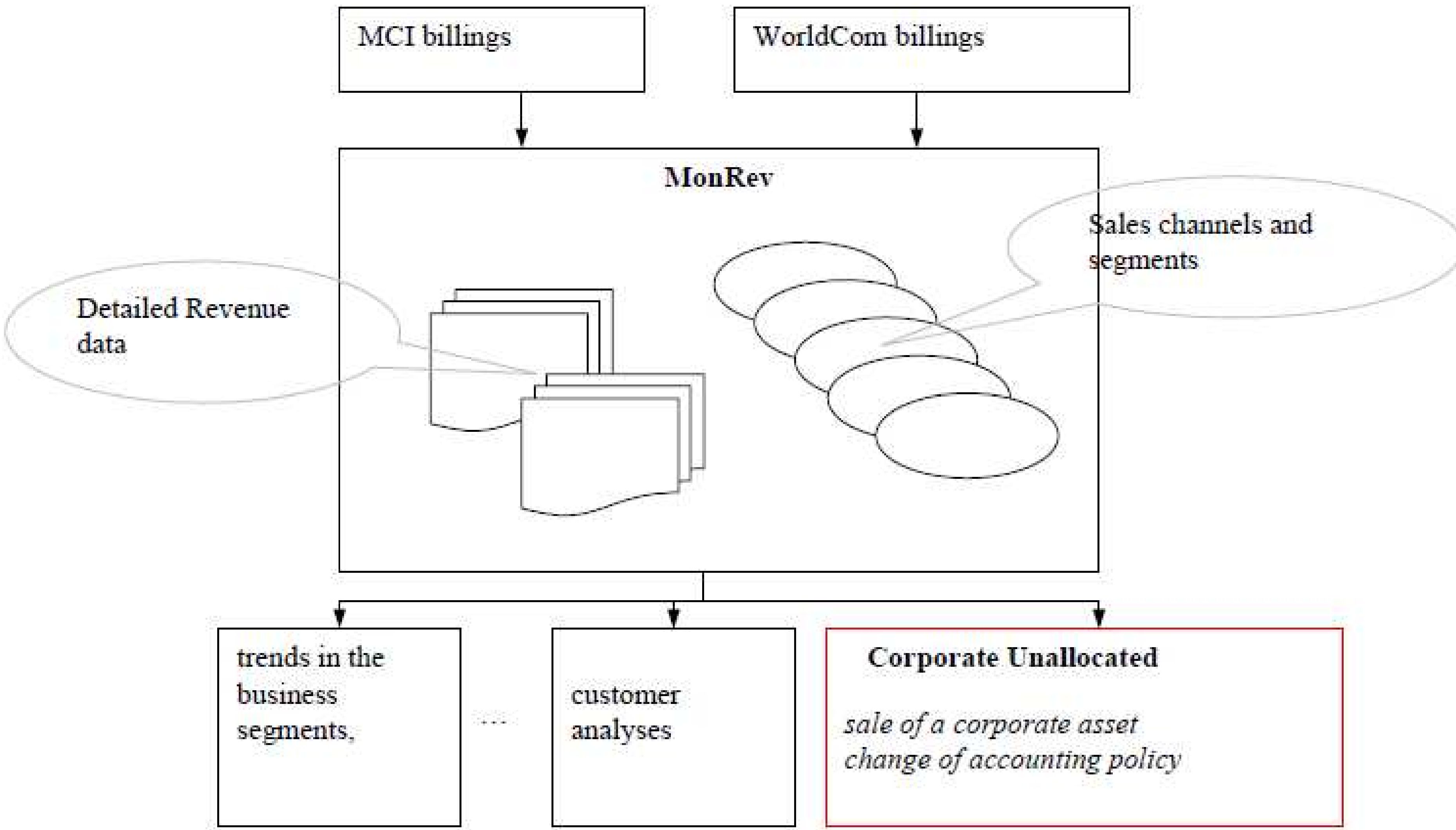
(millions of dollars)

	1Q01	2Q01	3Q01	4Q01	1Q02	Total
Capitalization	544	560	743	841	818	3,506
Other Adjustments	227	50	--	100	--	377
Total	771	610	743	941	818	3,883



	99	Adjusted	2000	Adjusted	2001	Adjusted	2002 1Q	Adjusted
Revenue	35,908	35,908	39,090	39,090	35,179	35,179	8,120	8,120
Line cost	14,739	15,337	15,462	18,332	14,739	17,802	3,479	4,277
Gross Profit	21,169	20,571	23,628	20,758	20,440	17,377	4,641	3,843
Operating income	7,888	7,290	8,153	5,283	3,514	451	843	45
Net Income	4,013	3,415	4,153	1,283	1,501	-1,562	172	-626
Asset	91,072	91,072	98,903	98,903	103,914	101,226	103,803	100,297
Gross Margin	59%	57%	60%	53%	58%	49%	57%	47.30%
Profit Margin	11%	9.50%	10.60%	3.30%	4.20%	-4.40%	2.10%	-7.70%
ROA	4.40%	3.70%	4.20%	1.30%	1.40%	-1.50%	0.18%	-0.60%
Line cost E/R	41%	42.70%	39.50%	47%	41.80%	50.60%	42.80%	52.60%

WorldCom Revenue manage mechanism



REVENUE INFLATION

- Between 1999 and the third quarter of 2001, WorldCom reported sustained and often impressive revenue growth.
- Entries were posted well after the end of the quarter; virtually all were booked to management-controlled revenue accounts (called "Corporate Unallocated" revenue accounts). Many of the largest of these management-directed accounting items were improperly recorded under GAAP.

Improper Revenue Entries
(millions of dollars)

1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	Total
85	5	65	50	19	121	161	27	17	132	117	92	67	**958**

Questionable Revenue Entries
(millions of dollars)

1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	Total
26	89	65	67	88	115	99	95	88	68	158	107	42	**1,107**

Adjustment of financial data for revenue only								
	99	Adjusted	2000	Adjusted	2001	Adjusted	2002 1Q	Adjusted
Revenue*	35,908	35,703	39,090	38,762	35,179	34,821	8,120	8,053
Line cost	14,739	14,739	15,462	15,462	14,739	14,739	3,479	3,479
Gross Profit	21,169	20,964	23,628	23,300	20,440	20,082	4,641	4,574
Net Income	4,013	3,808	4,153	3,825	1,501	1,313	172	150
Asset	91,072	91,072	98,903	98,903	103,914	103,914	103,803	103,803
Gross Margin	59%	58.70%	60%	60%	58%	57.60%	57%	56%
Profit Margin	11%	10.60%	10.60%	9.80%	4.20%	3.70%	2.10%	1.80%
ROA	4.40%	4.20%	4.20%	3.90%	1.40%	1.26%	0.18%	0.13%
E/R	41%	41.20%	39.50%	39.80%	41.80%	42.30%	42.80%	43.20%

*Questionable revenue inflation is not included.

ADDITIONAL ACCOUNTING ISSUES

Several improper adjustments with small effect on reported earnings:

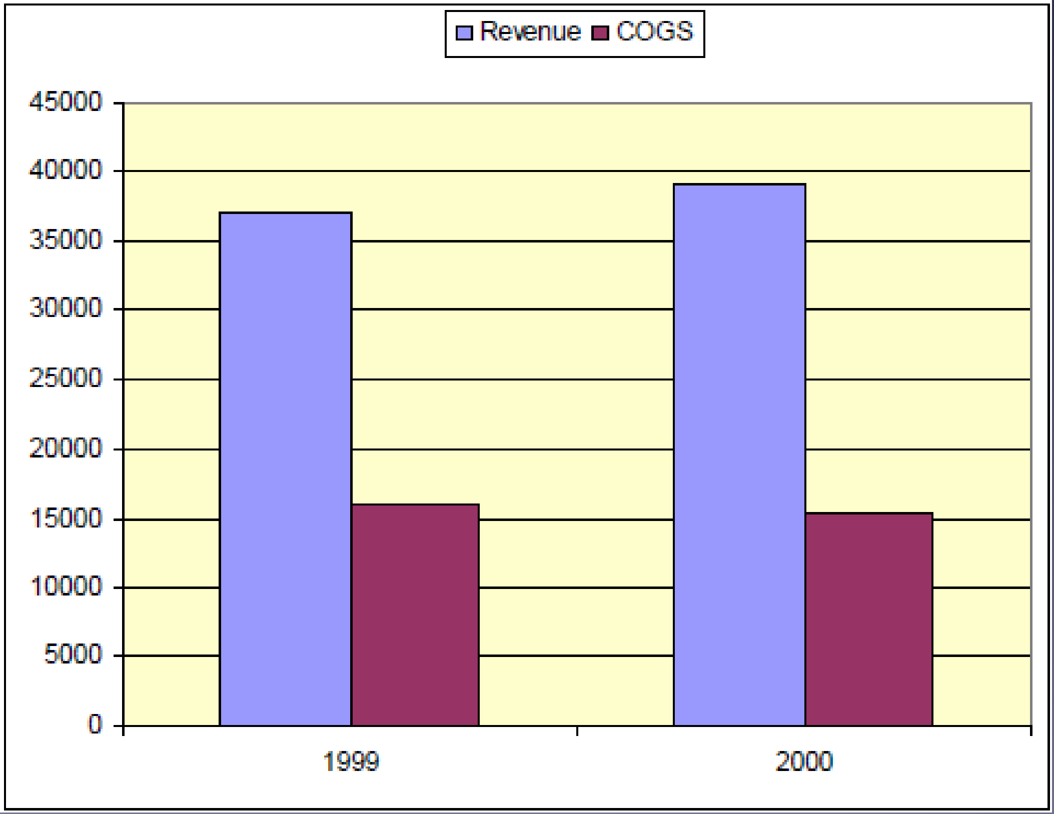
- Improper reduction of expenses: selling, general and administrative (“ SG&A”) costs; depreciation; and income taxes.
- Use of general accrual accounts to accumulate excess accruals from other accounts, to offset expenses for which they may not have been established originally, to replenish under-funded accruals, and to write down asset accounts, all so as to increase reported income.
- Concerns about the manner in which costs were allocated when WorldCom realigned its businesses and formed two tracking stocks, WorldCom Group and MCI Group.

Adjustment of financial data for line cost and revenue								
	99	Adjusted	2000	Adjusted	2001	Adjusted	2002 1Q	Adjusted
Revenue*	35,908	35,703	39,090	38,762	35,179	34,821	8,120	8,053
Line cost	14,739	15,337	15,462	18,332	14,739	17,802	3,479	4,277
Gross Profit	21,169	20,366	23,628	20,430	20,440	17,019	4,641	3,776
Net Income	4,013	3,210	4,153	955	1,501	-1750	172	-648
Asset	91,072	91,072	98,903	98,903	103,914	101,226	103,803	100,297
Gross Margin	59%	57%	60%	52.70%	58%	48.80%	57%	46.90%
Profit Margin	11%	8.90%	10.60%	2.50%	4.20%	-5%	2.10%	-8%
ROA	4.40%	3.50%	4.20%	1%	1.40%	-1.70%	0.18%	-0.62%
E/R	41%	42.90%	39.50%	47%	41.80%	51%	42.80%	53.10%
*Questionable revenue inflation is not included.								

WARNING SIGNS

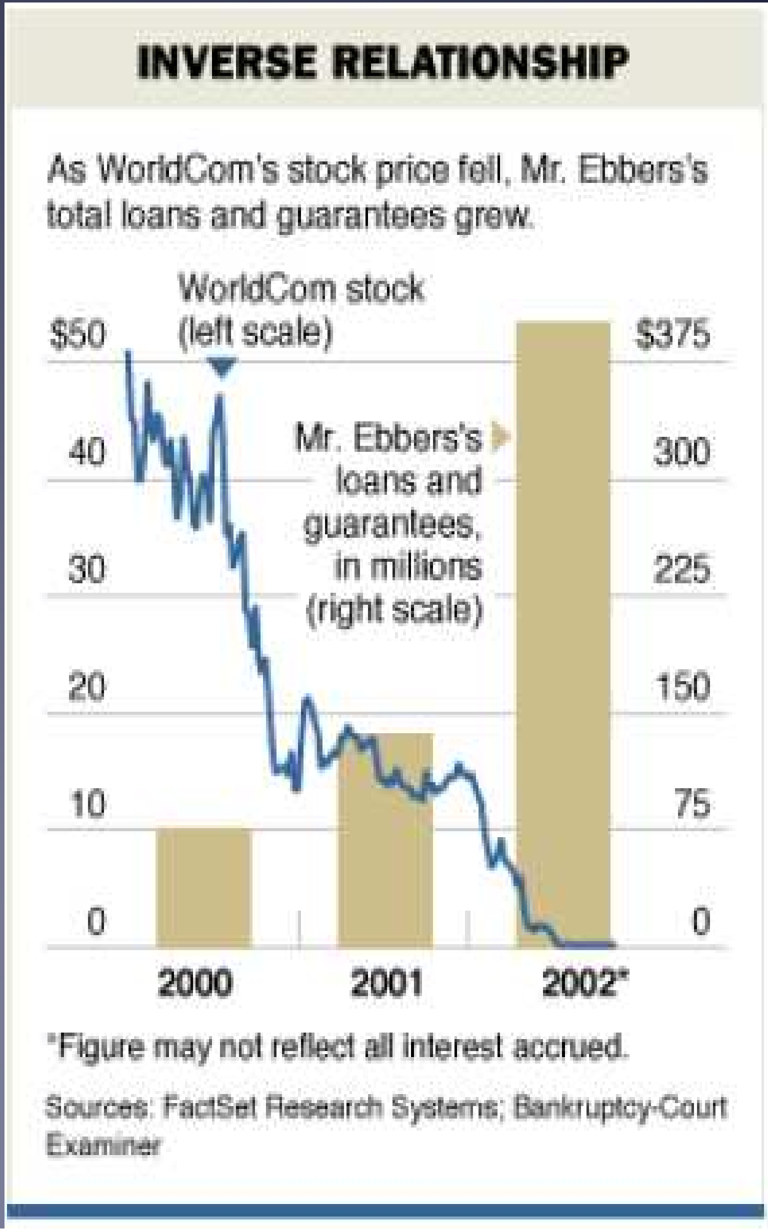
From 1999 to 2000

- Revenue increased from $37,120M to $39,090M
- Cost of goods sold decreased from $15,951M to $15,462M
- Operation efficiency constant



WARNING SIGNS (Cntd...)

- Net Income increased from $4,013M to $4,153M
- Accounts receivable increased from $5,746M to $6,815M
- Free cash flow decreased from $2,289M to $3,818M



Crooked accounting puts WorldCom on brink

In a statement Tuesday, WorldCom said its board of directors had found $3.8 billion was wrongly listed on its books as capital expenses in 2001 and 2002. That means WorldCom may have actually lost millions of dollars when it reported profits.

Sources: Associated Press; Yahoo.com; Commodity Systems Inc.; Quote.com

AP

CONSEQUENCES

- Mid 1999 - $64.50 a share
- Prior fraud announcement - $2
- After announcement – below $1

On July 21st, 2002 WorldCom filed for Chapter 11 bankruptcy protection

Sarbanes Oxley Act Overview-Corporate Governance and Disclosures

- Sarbanes-Oxley Act of 2002 (“SOA”) enacted July 30, 2002
- Corporate scandals (Enron, WorldCom) provided impetus for Congress to act quickly
- SOA approved by near unanimous vote in Congress (vote of 99-0 in the Senate and 423-3 in the House)
- Fast pace of approval likely to result in need for numerous interpretations and explanations
- Potential for far reaching impact on Corporate Governance and Conduct, Financial Reporting and the Public Accounting Profession
- Also impacts legal community and investment banking analysts

Sarbanes Oxley Act Overview- Corporate Governance and Disclosures

- Several provisions of the SOA require detailed regulations by the SEC and other regulatory bodies
- SOA aims to restore investor confidence in financial reporting and public capital markets
- Broadly speaking the Act's provisions seem to be built around the following principles:
  - Integrity
  - Independence
  - Proper Oversight
  - Accountability
  - Strong Internal Controls
  - Transparency
  - Deterrence